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NOTE

The Land of Opportunity Zones: Deferring Taxable Capital Gains Through Investments in Low-Income Communities

Reid S. Vardell*

I. INTRODUCTION

The market reserve of unrealized capital gains in the United States has grown to an estimated \$6 trillion.¹ A new program provides a novel way to incentivize investors into realizing those gains but deferring recognition, while at the same time helping to revitalize areas of America that need it most.²

The Opportunity Zone Program is a tax deferment scheme that serves as a tool to bring capital into underperforming areas³ by giving preferential tax treatment to realized capital gains reinvested in specific communities.⁴ The program aims to remedy the “profoundly uneven” economic recovery in the United States following the Great Recession of December 2007 to June 2009

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1. *The Promise of Opportunity Zones: Before the J. Econ. Comm.*, 115th Cong. 7 (2018) [hereinafter *The Promise of Opportunity Zones*] (statement of John Lettieri, CEO, Economic Innovation Group). At the end of 2015, U.S. households had an estimated \$2.3 trillion in unrealized capital gains, which increased to an estimated \$3.8 trillion by the end of 2017. *Id.* at 8. Another conservative estimate by the same group found a total of \$2.3 trillion in unrealized capital gains held by businesses. Jared Bernstein & Kevin A. Hassett, *Unlocking Private Capital to Facilitate Economic Growth in Distressed Areas*, ECONOMIC INNOVATION GROUP 1, 16 (April 2015) <https://eig.org/wp-content/uploads/2015/04/Unlocking-Private-Capital-to-Facilitate-Growth.pdf> [<https://perma.cc/8Q5Y-F8QM>].

2. *The Promise of Opportunity Zones*, *supra* note 1, at 7 (statement of John Lettieri, CEO, Economic Innovation Group).

3. Underperforming areas are defined as census tracts with a poverty rate of at least twenty percent or either a rural census tract with median family income that does not exceed eighty percent of the state median family income or a census tract in a metropolitan area where the median family income does not exceed the state or city median family income. I.R.C. § 1400Z-1(c)(1) (2012); I.R.C. § 45(d) (2012).

4. *The Promise of Opportunity Zones*, *supra* note 1, at 7–8 (statement of John Lettieri, CEO, Economic Innovation Group); I.R.C. § 1400Z-2 (2012).

where many areas still face high unemployment and low job opportunity despite robust economic recovery in more resilient urban areas.⁵ When jobs leave an area and unemployment increases, private investments and businesses start to move elsewhere.⁶ This causes a hollowing out of the area's tax base and a decline in revenue for local governments.⁷ Many workers stay in these distressed areas of high unemployment either by choice or necessity,⁸ which places a higher burden on the local government and established social safety nets.⁹ Economic concerns aside, workers in these distressed areas face higher instances of death or major illness, and their children are confronted with lower achievement outcomes and wages later in life.¹⁰ Many communities find themselves in this widening gyre where investors are reluctant to return to an area because of the lack of other investors.¹¹ Congress designed the Opportunity Zone Program as a tool to drive private equity capital back into these underperforming areas and jump-start the economic recovery process.¹²

This Note provides a discussion of the capital gains tax as a backdrop to the Opportunity Zones Program now found in Section 1400z of the Internal Revenue Code (the "Code"). The Note then examines aspects of the program that could lead to the program's success as well as some issues that could delay the program's adoption. Finally, the conclusion will juxtapose the Opportunity Zone Program with the New Market Tax Credit (the "NMTC") to evaluate the program's potential for overcoming past hurdles.

II. LEGAL BACKGROUND

The United States first introduced an income based tax to offset the mounting cost of the Civil War.¹³ It was not until the ratification of the Sixteenth Amendment to the Constitution that the concept of a federal income tax became a cornerstone of American taxation.¹⁴ At the time, the Code taxed all

5. Bernstein & Hasset, *supra* note 1, at 2.

6. *Id.*

7. *Id.* at 3.

8. *Id.*

9. Phil Oliff, Chris Mai & Vincent Palacios, *States Continue to Feel Recession's Impact*, CTR. ON BUDGET & POL'Y PRIORITIES (Jun. 27, 2012), <http://www.cbpp.org/files/2-8-08sfp.pdf> [perma.cc/5TRB-X6KC] (showing how state budgets had still not recovered several years after the Great Recession ended "principally from weak tax collection" and stating that the weak economy caused a higher burden on essential state services such as Medicaid).

10. Bernstein & Hasset, *supra* note 1, at 2.

11. *Id.* at 3.

12. *The Promise of Opportunity Zones*, *supra* note 1, at 7 (statement of John Lettieri, CEO, Economic Innovation Group).

13. See generally, Joseph A. Hill, *The Civil War Income Tax*, 8 Q. J. OF ECON. 416, (Jul. 1894).

14. U.S. CONST. amend. XVI.

income at the same rate, regardless of its source.¹⁵ This changed with the passage of the Revenue Act of 1921, which granted capital gains a substantially more favorable rate than ordinary income.¹⁶

Capital gain is realized “from the gain on the sale or exchange of a capital asset.”¹⁷ If the sale or exchange results in a loss, a capital loss is realized instead.¹⁸ Realized gains or losses generally must be recognized at the time they occur unless some non-recognition provision can be found in the Code. A capital asset is any “property held by the taxpayer,” subject to a number of exceptions, including inventory, property used in a trade or business subject to depreciation, all real property used in a trade or business, and patents or inventions in the hand of the creator.¹⁹ In the words of the Internal Revenue Service, “Almost everything you own and use for personal or investment purposes is a capital asset.”²⁰

Capital gain or loss is generally the difference between the amount the taxpayer receives for the asset and the taxpayer’s basis in the asset.²¹ A taxpayer’s basis in a capital asset consists of costs paid to acquire the asset increased by capital expenditures made to improve it.²² Capital gains are long-term if the asset is held for over one year or short-term if the asset is held for one year or less.²³ The Opportunity Zone Program targets these unrealized capital gains.

III. THE OPPORTUNITY ZONE PROGRAM

The strong Republican showing in the 2016 national election set the stage for the largest overhaul of the Tax Code in over thirty years. Republicans gained control of the executive branch while maintaining their majority in both houses of Congress.²⁴ Changes came in the form of Public Law 115-97, better

15. Phyllis C. Taite, *Saving the Farm or Giving Away the Farm: A Critical Analysis of the Capital Gains Tax Preferences*, 53 SAN DIEGO L. REV. 1017, 1021 (2016).

16. *Id.* Ordinary income was taxed at almost 70 percent while Capital Gains were reduced to a 12.5 percent tax. *Id.*

17. I.R.C. § 1222(3) (2012).

18. *Id.*

19. I.R.C. § 1221(a) (2012). For a more extensive discussion on exceptions, see SCOTT SHIMICK, MERTENS LAW OF FEDERAL INCOME TAXATION §§ 22:4–22:9, Westlaw (updated May 2019).

20. *Topic Number 409 – Capital Gains and Losses*, INTERNAL REVENUE SERVICE, (Mar. 13, 2018) <https://www.irs.gov/taxtopics/tc409> [<https://perma.cc/JN8H-LTRJ>].

21. *Id.*

22. I.R.C. § 1012(a) (2012).

23. I.R.C. § 1222. These two categories are currently taxed at different rates with a more favorable rate being given to long-term capital gains than short-term capital gains. See generally I.R.C. § 1 (2012).

24. *2016 Election Results*, CNN POLITICS (last visited Apr. 29, 2019) <https://www.cnn.com/election/2016/results>.

known as the Tax Cuts and Jobs Act (“TCJA”).²⁵ The TCJA had the dual goals of reducing tax burdens and simplifying the Tax Code but it managed to further complicate the taxation of capital gains with the inclusion of Subchapter Z – Opportunity Zones.²⁶ The Economic Innovation Group (“EIG”) first proposed Opportunity Zones in a 2015 paper entitled “Unlocking Private Capital to Facilitate Economic Growth in Distressed Areas.”²⁷ The Opportunity Zone Program has since gained bipartisan support during its implementation.²⁸

A. Additions to the Code

Under the program, a taxpayer can defer recognition of realized capital gains by investing those gains into underprivileged or underperforming regions designated as Opportunity Zones.²⁹ This section examines how Qualified Opportunity Zones are created, what requirements are imposed on Qualified Opportunity Funds (“QOFs”) and Qualified Opportunity Zone Businesses, and the types of property under the expansive umbrella of Qualified Opportunity Zone Property before finally looking at the treatment of realized capital gains invested with QOFs.

1. The Creation of Qualified Opportunity Zones

A Qualified Opportunity Zone is defined as “a population census tract that is a low-income community.”³⁰ To be considered a low-income community, a tract must either have: (1) a poverty rate of at least twenty percent, or (2) have a median income at or below eighty percent of the statewide median income.³¹ Currently, no new Qualified Opportunity Zones can be created. The designation process in the Code is limited to the ninety day window after the enactment of the TCJA with a possible thirty day extension.³² The Code grants designation authority to the highest state executive officer and mandates that those governors report selected census tracts to the Treasury Secretary.³³ The Code then gives the Secretary thirty days to certify the tract.³⁴ The designation

25. Tax Cuts and Jobs Act, Pub. L. No. 115-97, 131 Stat. 2054 (2017).

26. I.R.C. § 1400Z-2 (2012).

27. Bernstein & Hassett, *supra* note 1, at 20.

28. *The Promise of Opportunity Zones*, *supra* note 1, at 7 (statement of John Lettieri, CEO, Economic Innovation Group).

29. § 1400Z-2.

30. § 1400Z-1(a).

31. I.R.C. § 46D(e) (2012). The income requirement for metropolitan tracts must not exceed eighty percent of either the statewide median income or the metropolitan area median income, whichever is greater. *Id.*

32. § 1400Z-1(c)(2)(B).

33. § 1400Z-1(b)(1).

34. § 1400Z-1(b)(1)(B).

lasts until “the close of the 10th calendar year beginning on or after such date of designation.”³⁵

The Code also restricts the number of Qualified Opportunity Zones available to a state to no more than “[twenty-five] percent of the number of low-income communities in the State.”³⁶ The program guarantees states with less than 100 low-income communities a minimum of twenty five nominations.³⁷ The statute also grants Puerto Rico Qualified Opportunity Zone status in its entirety.³⁸ A tract that does not qualify as a low-income community can be designated as a Qualified Opportunity Zone if it is “contiguous with the low-income community that is designated as a qualified opportunity zone” and the income for that tract does not exceed “125 percent of the median family income of the low-income community with which the tract is contiguous.”³⁹ Bringing capital to these communities and having the capital considered a qualified investment is the job of QOFs.⁴⁰

2. The Moving Parts: Qualified Opportunity Funds, Qualified Opportunity Zone Businesses, and Qualified Opportunity Zone Business Property

A QOF is defined as “any investment vehicle which is organized as a corporation or a partnership for the purpose of investing in Qualified Opportunity Zone Property,” but the investment cannot include another QOF.⁴¹ QOFs self-certify by attaching a form to their tax returns and do not require government approval or certification before investing.⁴² QOFs must hold at least ninety percent of their investments in Qualified Opportunity Zone Property and are audited twice a year – once at the end of the sixth month of their taxable year and again on the final day.⁴³ Currently, the ninety percent test relies on the QOF’s financial statement or, in the absence of any statement, the cost of the fund’s assets.⁴⁴ To encourage QOFs to maintain the required amount of Qualified Opportunity Zone Property, the Code imposes a penalty against QOFs that drop below the ninety percent investment level, unless the

35. § 1400Z-1(f).

36. § 1400Z-1(d)(1).

37. § 1400Z-1(d)(2).

38. § 1400Z-1(b)(3).

39. § 1400Z-1(e)(1).

40. *The Promise of Opportunity Zones*, *supra* note 1, at 7 (statement of John Lettieri, CEO, Economic Innovation Group).

41. § 1400Z-2(d)(1).

42. Investing in Qualified Opportunity Funds, 83 Fed. Reg. 54279, 54283 (proposed Oct. 29, 2018) [hereinafter Investing in Qualified Opportunity Funds (Oct. 2018)].

43. § 1400Z-2(d)(1).

44. Investing in Qualified Opportunity Funds (Oct. 2018), *supra* note 42, at 54283.

deficiency is due to reasonable cause.⁴⁵ The penalty is proportional to the fund's deficiency.⁴⁶

Current proposed regulations suggest including cash as Qualified Opportunity Zone Property for purposes of the ninety-percent asset test.⁴⁷ Prior to this, investors expressed worries that the economic realities of developing a new business or real estate transaction might require a QOF to hold large amounts of cash for longer than six months, which would result in a penalty if the cash constituted more than ten percent of the QOF's total assets.⁴⁸ While not finalized, the plan would allow cash to be held for a period of thirty-one months only if the fund has a written plan and schedule for the deployment of the capital.⁴⁹

A Qualified Opportunity Zone Business is a trade or business that has "substantially all" of its owned or leased tangible property as Qualified Opportunity Zone Property.⁵⁰ It must derive at least fifty percent of its total gross income from active business within the Qualified Opportunity Zone, and that active business cannot be an excluded business activity.⁵¹ Qualified Opportunity Zone Businesses are prohibited from having non-qualified financial property, such as debt, options, or future contracts, make up more than five percent of their assets.⁵² The Treasury has proposed defining "substantially all" in relation to ownership of tangible property as seventy-percent of the business's owned or leased tangible property.⁵³

Qualified Opportunity Zone Property encompasses Qualified Opportunity Zone Stock, Qualified Opportunity Zone Partnership Interests, and Qualified Opportunity Zone Business Property.⁵⁴

45. § 1400Z-2(f). Reasonable cause is not currently defined by the Code or proposed regulations.

46. *Id.* The penalty is found by taking ninety percent of the firm's current assets and subtracting the amount of Opportunity Zone Property it currently owns multiplied by the underpayment rate from section 6621(a)(2) of the Code. *Id.*

47. Investing in Qualified Opportunity Funds (Oct. 2018), *supra* note 42, at 54284.

48. *Id.*

49. *Id.*

50. § 1400Z-2(d)(3).

51. *Id.* The full list of excluded businesses includes "any private or commercial golf course, country club, massage parlor, hot tub facility, suntan facility, racetrack or other facility used for gambling" or a business that exists to sell alcoholic beverages intended to be imbibed elsewhere. I.R.C. § 144(c)(6)(B) (2012).

52. I.R.C. § 1400Z-2(d)(3) (2012).

53. Investing in Qualified Opportunity Funds (Oct. 2018), *supra* note 42, at 54288. Allowing a Qualified Opportunity Zone Business to qualify with only seventy percent of its assets invested in Opportunity Zone Property would provide a greater incentive for QOFs to invest in businesses instead of directly owning property. *Id.* at 54284. QOFs are required to keep ninety percent of their assets as Qualified Opportunity Zone Business Property. *Id.* If a QOF decided to run a business instead of investing, the QOF would still have to meet the higher ninety percent requirement. *Id.*

54. § 1400Z-2(d)(2)(A) (2012).

The requirements to qualify as Qualified Opportunity Zone Stock and Partnership Interests are largely the same.⁵⁵ The corporation or partnership selling the interest must be a domestic entity, it must be a Qualified Opportunity Zone Business for “substantially all of the [QOF’s holding period or the Qualified Opportunity Zone Business’s] holding period,” and the stock or partnership interest must be acquired for cash after December 31, 2017.⁵⁶

Qualified Opportunity Zone Business Property includes tangible property used in the trade or business of a QOF or Qualified Opportunity Zone Business and acquired after December 31, 2017.⁵⁷ The program also requires that “during substantially all of the [QOF’s holding period or the Qualified Opportunity Zone Business’s] holding period for such property, substantially all of the use of such property was in a qualified opportunity zone.”⁵⁸ The function of the property within any given Qualified Opportunity Zone must be considered original use and must start with the QOF or Qualified Opportunity Zone Business.⁵⁹ Current regulations attach the concept of original use to depreciation and amortization.⁶⁰ Tangible property will meet the original use requirement if the property has not been placed into services in the Qualified Opportunity Zone in such a way that would allow another taxpayer to depreciate or amortize it.⁶¹ If the original use requirement is not met, the entity must substantially improve the property for it to qualify.⁶²

The Code considers a property substantially improved when additions to the property’s basis, in the form of capital expenditures, exceed the original adjusted basis in the property.⁶³ Substantial improvement is measured over a thirty-month period.⁶⁴ At the end of the measurement period, improvement expenditures must at least equal the adjusted basis of the property at the start of the thirty-month period.⁶⁵ If the property no longer qualifies as Opportunity Zone Business Property, the statute provides a grace period of either five years or until the sale of the property, whichever occurs first, before the property is no longer treated as Qualified Opportunity Zone Business Property.⁶⁶

The term “substantially all” is used in multiple sections of the statute and it does not always have the same meaning. As discussed above, a Qualified

55. §§ 1400Z-2(d)(2)(B)–(C).

56. *Id.* In the case of stock, the stock must also be acquired at its original issue through the corporation or an underwriter. § 1400Z-2(d)(2)(B)(i).

57. § 1400Z-2(d)(2)(D).

58. *Id.*

59. *Id.*

60. Investing in Qualified Opportunity Funds, 84 Fed. Reg. 18652, 18654 (proposed May 1, 2019) [hereinafter Investing in Qualified Opportunity Funds (May 2019)].

61. *Id.*

62. I.R.C. § 1400Z-2(d)(2)(D).

63. *Id.*

64. *Id.*

65. *Id.*

66. § 1400Z-2(d)(3)(B).

Opportunity Zone Business must have substantially all, or seventy percent, of its property as Qualified Opportunity Zone Property.⁶⁷ Requirements based on a QOF's holding period are found in Qualified Opportunity Zone Stock, Partnership Interests, and Business Property.⁶⁸ These require the corporation or partnership issuing the equity to maintain Qualified Opportunity Zone Business status for substantially all of the QOF's holding period.⁶⁹ Current regulations define requirements in reference to holding periods as ninety percent.⁷⁰ Qualified Opportunity Zone Business Property also requires that "during *substantially all* of the QOF's holding period for such property, *substantially all* of the use of such property was in a qualified opportunity zone."⁷¹ Again, the first instance of substantially all is ninety percent but the second has been defined as seventy percent to match the requirement first discussed with Qualified Opportunity Zone Business.⁷²

3. The Treatment of Capital Gains in Qualified Opportunity Zones

The Opportunity Zone Program allows a taxpayer to elect to defer recognition of capital gains if the taxpayer invests those gains into a QOF within 180 days of the realization event.⁷³ To accomplish this, the Code excludes capital gains from gross income up to the amount the taxpayer invests in a QOF.⁷⁴ Taxpayers can only make this election once for any amount of eligible gain,⁷⁵ but they can make the election multiple times with respect to the same sale so long as each election encompasses a different amount of the total eligible gain.⁷⁶ The sale triggering the excluded gain must be from an unrelated person.⁷⁷ The Opportunity Zone Program defines related parties by reference to section 267 and 707 of the Code but alters the definitions to be more restrictive.⁷⁸ It is easier for an entity and the taxpayer to be considered related.⁷⁹ For

67. See *supra* note 53 and accompanying text.

68. § 1400Z-2(d)(2).

69. *Id.*

70. Investing in Qualified Opportunity Funds (May 2019), *supra* note 60, at 18652, 18653.

71. § 1400Z-2(d)(2)(D)(i)(III) (emphasis added).

72. Investing in Qualified Opportunity Funds (May 2019), *supra* note 60, at 18652, 18653.

73. § 1400Z-(a)(1).

74. *Id.*

75. § 1400Z-2(a)(2).

76. Investing in Qualified Opportunity Funds (Oct. 2018), *supra* note 42, at 54281.

77. § 1400Z-2(a)(1).

78. § 1400Z-2(e)(2) (Changing all instances of "[fifty] percent" to "[twenty] percent"). The Code defines relation to the taxpayer by reference to section 267(b), dealing with taxable income in reference to related taxpayers, and section 707(b)(1) which deals with transactions between a partner and partnership. See I.R.C. §§ 267, 707 (2012).

79. § 1400Z-2(e)(2)

example, under section 267(b)(2), a taxpayer and a corporation are related when the taxpayer owns fifty percent of the corporation's outstanding shares.⁸⁰ Under the Opportunity Zone Program, a taxpayer and a corporation are related when the taxpayer owns more than twenty percent of the outstanding shares.⁸¹

The two main benefits of the Opportunity Zone Program are (1) the deferral of gain recognition and (2) the reduction of the amount of gain ultimately recognized.⁸² First, taxpayers can defer recognition of capital gains until the earlier of the sale of the investment in the QOF or December 31, 2026.⁸³ Second, the amount of deferred gain the taxpayer ultimately has to recognize is reduced by ten percent if the investment is held for five years⁸⁴ and by a cumulative total of fifteen percent if it is held for seven years.⁸⁵

To calculate this reduction, the Code first sets the basis of the investment in the QOF to zero.⁸⁶ The investment basis is then increased by ten percent of the total amount of gain deferred once it is held for five years and an additional five percent after it is held for seven years.⁸⁷ The amount of deferred gain recognized by the taxpayer on the sale or exchange of the QOF investment is the difference between the total amount of gain deferred and the basis of the QOF investment.⁸⁸ The basis in the QOF investment is increased by the amount of deferred gain recognized, ensuring the taxpayer is not taxed on that amount again when selling or exchanging the QOF investment.⁸⁹

For example, consider a taxpayer who invests \$100 of realized capital gains in a QOF. The taxpayer would defer recognition of that realized gain and have a basis of zero in the QOF investment. After five years, the basis in the QOF investment would increase by ten percent to \$10 and after an additional two years the basis would increase to \$15. When the taxpayer then sells the QOF investment after the seventh year for \$110, they must recognize their deferred gain. The amount of deferred gain the taxpayer must recognize is the difference between the amount of gain the taxpayer excluded, \$100, and the basis in the QOF investment, \$15. In this example, the taxpayer would recognize \$75 of the initial deferred gain as income. This recognition then increases the basis of the QOF investment by \$75 to \$100, or the total amount of deferred gain. This increased QOF investment basis is then used to calculate any gain or loss the taxpayer realized from the sale of the QOF investment. Here the taxpayer would realize a \$10 gain on the QOF investment but, as discussed immediately below, that does not have to be the case.

80. I.R.C. § 267(b)(2) (2012).

81. I.R.C. § 1400Z-2(e)(2).

82. § 1400Z-2(b).

83. § 1400Z-2(b)(1).

84. § 1400Z-2(b)(2)(iii).

85. § 1400Z-2(b)(2)(iv).

86. 1400Z-2(b)(2)(B)(i).

87. §§ 1400Z-2(b)(2)(B)(ii)–(iv).

88. § 1400Z-2(b)(2)(A).

89. § 1400Z-2(b)(2)(B)(ii).

A taxpayer will not have realized gains on a QOF investment if the investment is held for at least ten years.⁹⁰ After the ten year mark, the basis in the QOF investment is increased to fair market value at the time of the sale or exchange.⁹¹ This final benefit protects the taxpayer from having to recognize any gain on the investment in the Opportunity Zone Program because they do not generate any realized gain on the sale or exchange of the QOF investment.

The statute's language does not expressly allow existing investments to qualify for this provision after the Qualified Opportunity Zone loses its ten-year designation.⁹² In order to quell investor fear, regulations have proposed a rule providing the ten year basis increase is not impaired "solely because . . . the designation of one or more qualified opportunity zones ceases to be in effect."⁹³ The proposed regulations also provide an extra ten-year period for investments to be sold once they have qualified for the ten year basis increase to allow the taxpayer to better plan their sale of the QOF investment.⁹⁴

B. The New Market Tax Credit

The statutory language for the Opportunity Zone Program includes several references to the NMTC.⁹⁵ Congress enacted the NMTC on December 12, 2000, as part of the Community Renewal Tax Relief Act.⁹⁶ The program was meant to bring investment capital to low-income communities in the form of equity or loans.⁹⁷ The Community Development Financial Institutions Fund ("CDFI")⁹⁸ administers the NMTC program which distributes tax credits to the limit authorized by Congress.⁹⁹ The process for obtaining the credit has been criticized as overcomplicated because it involves a cumbersome certification process for Community Development Entities ("CDEs") and high transaction

90. § 1400Z-2(c).

91. § 1400Z-2(b)(2)(c).

92. *Id.*

93. Investing in Qualified Opportunity Funds (Oct. 2018), *supra* note 42, at 54292.

94. *Id.* at 54283.

95. I.R.C. § 45D (2012). See also Bob Ibanez, *Opportunity Zones: An Opportunity to Apply Lessons Learned from the New Markets Tax Credit Program*, NOVogradac & Co. LLP (Sep. 26, 2018), <https://www.novoco.com/notes-from-novogradac/opportunity-zones-opportunity-apply-lessons-learned-new-markets-tax-credit-program> [perma.cc/LN23-YTER].

96. Susan R. Jones, *Will New Markets Tax Credits Enhance Community Economic Development?*, 8 J. SMALL & EMERGING BUS. L. 229, 230 (2004).

97. *Id.* at 231.

98. *New Markets Tax Credit Program*, COMMUNITY DEV. FIN. INSTITUTIONS FUND, <https://www.cdfifund.gov/programs-training/Programs/new-markets-tax-credit/Pages/default.aspx> (last visited June 9, 2019) [perma.cc/AU85-J7DE].

99. I.R.C. § 45D(f) (2012).

costs due to the number of parties required.¹⁰⁰ Taxpayers who invest with CDEs gain the benefit of a tax credit but only after making a Qualified Equity Investment (“QEI”) with a Qualified Active Low-Income Community Business (“QALICB”) – all subject to the approval of the CDFI.¹⁰¹ The tax credit can then be transferred from the CDE to the investor.¹⁰² The taxpayer is able to apply the thirty-nine percent tax credit over the next seven years while “substantially all” of the investment is still in a Qualified Low-Income Community Investment (“QLICI”).¹⁰³ CDEs meet the substantially all requirement by keeping eighty-five percent of the investor’s investment in the QALICB.¹⁰⁴ The federal government can recapture the tax credit from the taxpayer if the CDE withdraws the investment before the full seven years.¹⁰⁵

The CDFI handles CDE classification, which requires the CDE to have a community member on its board and a primary mission to serve the needs of low-income communities.¹⁰⁶ After finding an investment opportunity, CDEs must apply to the CDFI again to receive approval for the investment and ultimately the actual tax credit.¹⁰⁷ The CDFI examines investments to judge capitalization, overall business strategy, management capacity, and community impact before approving or rejecting the investment.¹⁰⁸ This process is not guaranteed to yield a credit nor is it noted for its efficacy; in the first five years of the program, 77% of all NMTC applications were denied.¹⁰⁹ Most of the projects utilizing the NMTC have been real estate transactions involving debt financing rather than equity.¹¹⁰

IV. DISCUSSION

The Opportunity Zone Program provides investors with deferral of realized gains while infusing much needed capital into blighted areas. First, this Section examines what the program does well and what could hold it back. The discussion then moves to examine the Opportunity Zone Program against the NMTC. Finally, the Note concludes with an examination of the type of regulations needed for a smooth rollout and successful adoption of the Opportunity Zone Program.

100. Manuel Andrés Giner, *Missing the Mark: Why the CRA and NMTC Have Failed to Develop the Inner City*, 41 RUTGERS L. REC. 177, 197 (2014).

101. § 45D(f)(2).

102. Giner, *supra* note 100, at 197.

103. § 45D(a)(2). *See also*, Giner *supra* note 100, at 196.

104. § 45D(b)(3).

105. § 45D(g); Giner *supra* note 100, at 196.

106. § 45D(c)(1).

107. § 45(c)(1)(C).

108. § 45D(d)(1).

109. Giner *supra* note 100, at 198.

110. *Id.* at 198–99.

A. Positive Aspects of the Program

It can be easy to get carried away focusing on capital gains and the possibility of a diminished tax burden, but it is important to remember the driving purpose behind the Opportunity Zone Program: helping people get back on their feet by bringing jobs back to their communities. The program has a number of positive mechanics to help it achieve this goal. First and foremost, the increased amount of local involvement will help direct funds to where they can do the most good. Second, the program was built with a great deal of flexibility that will allow it to adapt to a multitude of different communities. Finally, the program is designed to be used in conjunction with other already available tools, and that synergy will be important in addressing the complex problems these areas face.

The amount of local involvement is one of the most beneficial aspects of the program.¹¹¹ Senator Tim Scott, a co-author of the original legislation, believed “the closer the government is to the people, the more the people trust that government,” and that sentiment echoes through the program’s structure.¹¹² State governors were given the final say to select areas they believe would be most responsive to outside investment.¹¹³ Governors were encouraged to get input from “mayors, county commissioners, and local economic development organizations” during the selection process to ensure the creation of Qualified Opportunity Zones that would truly serve the community and benefit the people.¹¹⁴ The inclusion of city and county officials is particularly important because it shows investors that local officials have confidence in the program and intend to stand by their communities. In this way, the program identifies and targets communities that will have the strongest reaction in a triage like fashion.¹¹⁵

Scaling a community sized program to the national level always comes with some bottlenecks, but the Opportunity Zone Program has enough flexibility to avoid these problems.¹¹⁶ Mr. John Lettieri, the co-founder and president

111. § 1400Z-1(b).

112. *The Promise of Opportunity Zones*, *supra* note 1, at 6 (statement of Sen. Tim Scott).

113. *Id.* at 38.

114. ECONOMIC INNOVATION GROUP, OPPORTUNITY ZONES: A NEW ECONOMIC DEVELOPMENT TOOL FOR LOW INCOME COMMUNITIES: GUIDANCE FOR GOVERNORS (Feb. 2018) <https://eig.org/wp-content/uploads/2018/02/Guidance-for-Governors-FINAL.pdf> [perma.cc/73E5-88KJ].

115. *The Promise of Opportunity Zones*, *supra* note 1, at 8 (statement of John Lettieri, CEO, Economic Innovation Group); *Qualified Opportunity Funds Provide New Tax Incentives for Investors*, PRICEWATERHOUSECOOPERS 1, 1 (Mar. 21, 2018), <https://www.pwc.com/us/en/tax-services/publications/insights/assets/pwc-qualified-opportunity-funds-tax-incentives-for-investors.pdf> [perma.cc/A6Y6-GW5D].

116. *Qualified Opportunity Funds Provide New Tax Incentives for Investors*, *supra* note 115, at 2.

of EIG, developed the program with an eye towards filling the diverse needs experienced by different communities.¹¹⁷ Lettieri believed flexible investments and the involvement of local officials would be necessary to increase the scale of the program.¹¹⁸ The reduced federal footprint on the program will also help it grow as it scales.¹¹⁹ The IRS has stated that QOFs will self-certify on their tax return without the need for prior approval from a federal agency.¹²⁰ This informal organization process will allow QOFs the freedom to fill community needs as they develop, which will be important to the program's overall success. Local community groups have noted the ease of establishing these funds as a great step forward.¹²¹

The flexible treatment of investments is another aspect that will contribute to the program's success and adoption. The lack of any maximum contribution or limit on the number of investments makes the program more flexible and accommodating to a number of investors.¹²² Multiple investors can pool their funds into one QOF, which opens the program to a greater number of taxpayers and even more sources of revenue that might be missed by programs with a high barrier of entry.¹²³ The mechanics of QOFs allow for money to be reinvested from one investment to the next more easily than in past programs.¹²⁴ The freedom of movement will increase the amount of equity investments, which are valued in part based on their flexibility.¹²⁵

Finally, the potential for synergy between the Opportunity Zone Program and other tax incentives will ensure the program is utilized to its fullest. The program was designed to complement existing community development tools.¹²⁶ Pairing with other programs, such as the Low Income Housing Tax

117. John W. Lettieri, *The Promise of Opportunity Zones* 1, 7 (May 17, 2018), https://www.jec.senate.gov/public/_cache/files/a5c8907c-d1a9-47c4-99ad-6c9fc1d7727c/john-lettieri-testimony.pdf [perma.cc/ZBB4-GKRR].

118. *Id.* at 2.

119. Letter from Jeffrey D. DeBoer, President and CEO, Real Estate Roundtable, to The Honorable David J. Kautter, Assistant Sec'y of Tax Policy, U.S. Dep't of Treasury 2 (June 28, 2018), https://www.novoco.com/sites/default/files/atoms/files/real_estate_roundtable_oz_guidance_comment_letter_062818.pdf [perma.cc/E&G2-DZVR].

120. Investing in Qualified Opportunity Funds (Oct. 2018), *supra* note 42, at 54281.

121. *Mike Ballard & Rodney Tucker – New Markets Tax Credits & Qualified Opportunity Zones Funds*, LAS VEGAS ROTARY CLUB (Aug. 23, 2018) (downloaded using iTunes).

122. *The Promise of Opportunity Zones*, *supra* note 1, at 8 (statement of John Lettieri, CEO, Economic Innovation Group).

123. *Mike Ballard & Rodney Tucker – New Markets Tax Credits & Qualified Opportunity Zones Funds*, *supra* note 121 (noting an investor does not have to be rich to participate).

124. Giner, *supra* note 100, at 198.

125. *Id.*

126. Lettieri, *supra* note 117, at 2.

Credit (“LITHC”)¹²⁷ and the NMTC,¹²⁸ is an important factor for community groups because it will allow communities to fill the gap of equity investments left open by other programs.¹²⁹ This could also help remedy the recent reduction in demand for LITHC¹³⁰ by providing an additional stream of investments where none existed before.¹³¹

B. Negative Aspects of the Program

While this new tax tool has impressed many, some view the rollout with caution. Congress removed a provision requiring the Treasury to issue a report to Congress on the program’s progress before it passed the TCJA.¹³² This provision would have required the Treasury to track the program’s investments and create an assessment of its impact and outcomes at the five-year mark.¹³³ The ability to assess if the program is achieving its intended goals is vitally important to its continued life, as demonstrably successful programs have an easier path to renewal. Further, this data will be important when amending this program or implementing future iterations of it.¹³⁴ The ability to track the progress and impact of these investments is critical to the future of the Opportunity Zone Program.

The current state of regulations is also troubling to both investors¹³⁵ and community organizations.¹³⁶ While some worry about overregulation stopping the flow of capital through restrictive delays,¹³⁷ others are more concerned with

127. I.R.C. § 42 (2012).

128. I.R.C. § 45D (2012). For a more comprehensive discussion of the NMTC *see infra* Part III.B.

129. *The Promise of Opportunity Zones Before The Joint Econ. Comm.*, 115th Cong. (2018) (testimony of John Lettieri, CEO, Economic Innovation Group).

130. The TCJA reduced the corporate tax rate to twenty-one percent which reduced the incentive for businesses to invest in the LIHC program because they had less of a tax liability to offset. Nicole DuBois, Amanda Gold & Corianne Scally, *How the Tax Cuts and Jobs Act Puts Affordable Housing Production at Risk*, URBAN INST. (July 12, 2018), <https://www.urban.org/urban-wire/how-tax-cuts-and-jobs-act-puts-affordable-housing-production-risk> [perma.cc/K4E4-5CKU].

131. *The Promise of Opportunity Zones*, *supra* note 1, at 69 (response from Terri Ludwig, CEO, Enterprise Community Partners, for questions submitted by Sen. Klobuchar).

132. *The Promise of Opportunity Zones*, *supra* note 1, at 15 (testimony of Representative Carolyn Maloney).

133. *Id.*

134. *Qualified Opportunity Funds Provide New Tax Incentives for Investors*, *supra* note 117, at 1; Jared Bernstein & Kevin A. Hassett, *supra* note 1, at 8.

135. DeBoer, *supra* note 119, at 2.

136. *The Promise of Opportunity Zones*, *supra* note 1, at 70 (response from Terri Ludwig, CEO, Enterprise Community Partners, for questions submitted by Sen. Klobuchar).

137. DeBoer, *supra* note 119, at 2.

underregulation potentially harming the very communities the program intends to help.¹³⁸ Either way, investors need clarification to calm angst, solidify confidence, and encourage participation at these early stages of the program.¹³⁹

The statute calls for Treasury Regulations to prevent abuse of the program and to clarify the certification process of QOFs.¹⁴⁰ Terri Ludwig, CEO of Enterprise Community Partners, specifically called for a regulation defining abuse to include “investments that adversely affect low-income residents.”¹⁴¹ Proposed regulations allow a transaction to be reclassified if “a substantial purpose of the transaction is to achieve a tax result that is inconsistent with the purposes of [the program],” but they do not address the concerns raised by community organizations.¹⁴² It is still unclear if the anti-abuse regulation will be applicable to adversely affected low-income residents. Anti-abuse regulations might not be the first thing investors look for, but this kind of guidance would provide communities some assurance that the program will actually benefit them. Commentators have also called for the QOF certification process to be more involved and include “an explicit commitment to benefiting local residents and businesses” along the same lines as the NMTC’s CDEs.¹⁴³ Guidance on these topics is still lacking but has been promised in the current proposed regulations.¹⁴⁴

Uncertainty as to which investments qualify as Qualified Opportunity Zone investments has created fears of a slow program launch, specifically in real estate development.¹⁴⁵ Concern over the requirement of “original use” has stoked worries of strict regulatory limits making the purchase and renovation

138. *The Promise of Opportunity Zones*, *supra* note 1, at 69 (response from Terri Ludwig, CEO, Enterprise Community Partners, for questions submitted by Sen. Klobuchar).

139. Kenneth J. Betts et. al., *Opportunity Zone Funds Offer New Tax Incentive for Long-Term Investment in Low-Income Communities*, SKADDEN, ARPS, SLATE, MEAGHER & FLOM LLP (Aug. 1, 2018), <https://www.skadden.com/insights/publications/2018/08/opportunity-zone-funds-offer-new-tax-incentive> [perma.cc/CX3P-SJ8Q].

140. I.R.C. §§ 1400Z-2(e)(4) (2012).

141. *The Promise of Opportunity Zones*, *supra* note 1, at 10 (statement of Terri Ludwig, CEO, Enterprise Community Partners).

142. Investing in Qualified Opportunity Funds (May 2019), *supra* note 60, at 18652, 18669.

143. Terri Ludwig, *The Promise of Opportunity Zones* 1, 4 (May 17, 2018), https://www.jec.senate.gov/public/_cache/files/7e775795-e97a-42d8-a8e3-916236ec13e1/terri-ludwig-testimony.pdf [perma.cc/MTE2-SX3U].

144. Investing in Qualified Opportunity Funds (Oct. 2018), *supra* note 42, at 54280.

145. DeBoer, *supra* note 119, at 2.

of vacant buildings burdensome.¹⁴⁶ The current rule requires a building be vacant for a period of five years before being purchased by a QOF or Qualified Opportunity Zone Business.¹⁴⁷

Some groups have also voiced the same concern over the “substantial improvement” threshold imposed when purchasing real estate.¹⁴⁸ Proposed regulations currently apply the substantial improvement test to buildings but not land.¹⁴⁹ Even so, critics say the test is a much higher burden than those found in other sections of the Code and have suggested a lower bar.¹⁵⁰ For instance, renovations can qualify for the LITHC if over a twenty-four month period, they equal at least twenty percent of the adjusted basis of the building.¹⁵¹ The higher burden placed on Qualified Opportunity Zone Property might be by design, as other commentators believe the “intent is not to have investors buy buildings or land simply to be held for long term investment.”¹⁵² The regulations have not budged on the improvement requirement perhaps confirming the purpose of burden.¹⁵³

In the background of this uncertainty and risk lurks the looming deadline of 2019 to qualify for the full seven-year, fifteen percent basis increase.¹⁵⁴ While regulators have not confirmed that investments cannot qualify for the basis increase after 2019, it would be prudent to consider it a hard deadline until enacted regulations say otherwise, although a number of sources speculate that such an investment would qualify.¹⁵⁵

146. *Id.* at 4; Betts, et al., *supra* note 139; Mike Ballard & Rodney Tucker – *New Markets Tax Credits & Qualified Opportunity Zones Funds*, *supra* note 123 (stating that one has to buy land and improve it and that buying structures isn’t worth it because of the additional costs).

147. Investing in Qualified Opportunity Funds (May 2019), *supra* note 60, at 18652, 18654.

148. Mike Ballard & Rodney Tucker – *New Markets Tax Credits & Qualified Opportunity Zones Funds*, *supra* note 123.

149. Investing in Qualified Opportunity Funds (Oct. 2018), *supra* note 42, at 54279.

150. Mike Ballard & Rodney Tucker – *New Markets Tax Credits & Qualified Opportunity Zones Funds*, *supra* note 123.

151. DeBoer, *supra* note 119, at 5.

152. *Qualified Opportunity Funds Provide New Tax Incentives for Investors*, *supra* note 115, at 4.

153. Peter Lawrence, Michael Novogradac & John Sciarretti, *New Opportunity Zones Could be Used to Finance Rental Housing*, NOVOGRADAC & CO. LLP (Feb. 23, 2018), <https://www.novoco.com/notes-from-novogradac/new-opportunity-zones-could-be-used-finance-rental-housing> [perma.cc/VD93-MFTS].

154. Betts, et al., *supra* note 139.

155. *Id.*; *Qualified Opportunity Funds Provide New Tax Incentives for Investors*, *supra* note 117, at 1; DeBoer, *supra* note 119, at 2.

C. Improvements and Changes Made from Other Programs

The Opportunity Zone Program is the next notable geographically targeted program directed towards low-income areas since the establishment of the NMTC.¹⁵⁶ The drafters of the program modeled its structure partly based on the NMTCs, but the program does not follow the exact same track. Both programs target low-income areas and attempt to drive investments through tax incentives, but they differ in a number of important ways.¹⁵⁷

The Opportunity Zone Program pulls funds from different sources than the NMTC. While the NMTC provided a tax credit for investors, it did not tap into new sources of capital or encourage the creation of new investment pipelines.¹⁵⁸ The NMTC was successful at reinvigorating current investments, but one of its shortcomings was its inability to generate new capital streams into communities.¹⁵⁹ By contrast, the Opportunity Zone Program targets unrealized capital gains that were previously locked into other investments.¹⁶⁰ This adds new money to communities rather than reshuffling existing capital from one project to another. The NMTC is also limited in size by congressional appropriations.¹⁶¹ The Opportunity Zone Program self-regulates in the sense that it will continue to generate new investments so long as the demand for capital in an area can sustain them. The program is a market-driven force that will expand to the extent the invisible hand will allow.

Along with separate sources of capital, the two programs draw from different pools of investors. The NMTC largely draws from major banks and other “for-profit self-financed investors.”¹⁶² It is less appealing to individual investors partially due to high transaction costs and complexity.¹⁶³ The Opportunity Zone Program is designed to appeal more to individuals.¹⁶⁴ The ability to pool money with other investors in QOFs, without having to wait for CDFI approval of the fund or investment, reduces burdens that prevented the NMTC

156. Ibanez, *supra* note 95.

157. *Id.* Both require less than five percent nonqualified financial property, both require at least 50 percent of a business’ profits come from active conduct in a specific zone, and both prohibit “sin” businesses from qualifying. *Id.*

158. *Id.*

159. Jared Bernstein & Kevin A. Hassett, *supra* note 1, at 10–11.

160. Adam Shell, *S&P 500 hits record high as earnings eclipse trade war fears*, USA TODAY (Aug. 21, 2018), <https://www.usatoday.com/story/money/2018/08/21/stocks-hit-record-highs/922315002/> [perma.cc/A89D2-G44U].

161. Bernstein & Hassett, *supra* note 1, at 6.

162. Giner *supra* note 100, at 197.

163. *Id.*

164. *The Promise of Opportunity Zones*, *supra* note 1, at 12 (statement of Maurice A. Jones, President and CEO, Local Initiatives Support Corporation).

from being more effective.¹⁶⁵ Indeed, the low barrier to entry gives the program the potential to grow much larger in size and scope than the NMTC.

QOF self-certification is another massive improvement from NMTC CDEs.¹⁶⁶ The NMTC's CDEs are very similar to QOFs, but CDEs are required to have a primary mission of "serving or providing investment capital for low-income communities or low-income persons" while being accountable to the community and certified by the Treasury.¹⁶⁷ Some commentators are calling for regulators to add a similar mission statement requirement to QOFs while others view these requirements as too restrictive and blame them for limiting the scope of the NMTC.¹⁶⁸ Pending final approval, the current plan is for QOFs to simply submit Form 8996 with their tax returns instead of applying to a federal agency and waiting to hear if they are allowed to invest in a community.¹⁶⁹ Taxpayers would also use this form for compliance with the "90-Percent Asset Test."¹⁷⁰

Some provisions of the Opportunity Zone Program seem designed to avoid the real estate holding pitfall into which the NMTC program fell.¹⁷¹ NMTC investors prefer long-term real estate holding over investing in active businesses because it is easier to comply with the program's rules while avoiding the realization of gains until the investor decides to initiate a sale.¹⁷² This proves detrimental to communities because investing directly in local business has a higher potential for expansion and job growth than real estate.¹⁷³ The CDFI added a question to their scrutiny of investment applications in an attempt to discourage this real estate focus.¹⁷⁴ The requirement that a property be substantially improved by providing a basis increase of 100% seems to address a real estate bias developing in the program.¹⁷⁵

D. Moving Forward

This program will live or die by its ability to track how well it can bring private investors on board in the early stages. To that end, several actions are needed to bolster investor confidence and solidify the program. First and foremost, official tracking of the program's effectiveness and impact is imperative. Second, future regulations should focus on preventing abuse and defining the

165. Lettieri, *supra* note 117, at 2.

166. *Id.*

167. DeBoer, *supra* note 119, at n.2.

168. *Id.*

169. Investing in Qualified Opportunity Funds, *supra* note 42, at 54283.

170. *Id.*

171. Ibanez, *supra* note 95.

172. Bernstein & Hassett, *supra* note 1, at 10; Giner *supra* note 102, at 197.

173. Bernstein & Hassett, *supra* note 1, at 10.

174. Ibanez, *supra* note 95.

175. I.R.C. § 1400Z-2(d)(2)(D)(ii) (2012); *see generally* Bernstein & Hassett, *supra* note 1, at 18.

time allotted for a QOF to reinvest capital. Finally, the program's time restraints should be expanded to allow investors to warm up to the program.

Accurate and comprehensive reporting on the program's effectiveness and on financial returns to investors would be a useful asset for the program. With more data, local officials could better market these zones to investors. Zone advocacy is a crucial component to the success of the program, and local governments need data and resources to help sell these investments. This not only shows local confidence but also communicates the kind of long-term commitments local officials and groups are willing to make to improve these zones.

An increased time period for implementation would allow private investors some needed breathing room when deciding whether to adopt the program. In the past, investor adoption has been limited by a program's complexity and the complexity of the Code.¹⁷⁶ Investors with a working financial plan are reluctant to adopt new programs that expose them to risk.¹⁷⁷ Providing extensions to the 180-day initial investment time and clarifying hard deadlines for maximizing returns would give investors more room to plan their entrance into the program.

V. CONCLUSION

America stands at the brink of implementing a massive market-driven incentive that can deliver new investment capital to struggling communities. This kind of program is an oddity or quirk in the market, but it should be made the rule rather than the exception. Making this targeted incentive program permanent would give underperforming communities the benefit of planning for growth without worrying about the exodus of investments once investors qualify for the ten year QOF basis increase. Congress initially taxed capital gains at a lower rate to incentivize the selling of long-held capital assets, and with an estimated reserve of several trillion dollars, it could be argued that the lower rate alone has not done its job.¹⁷⁸ Creating a permanent program in the structure of the Opportunity Zone Program's mold will provide that needed incentive and hopefully capture some of these gains before they receive a stepped-up basis as part of a taxpayer's estate.

176. Bernstein & Hassett, *supra* note 1, at 11.

177. *Id.* at 16.

178. *Id.* at 16–17.